Preparing for Next Steps on Better Economic Governance in the Euro Area

Analytical Note

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in close cooperation with

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Introduction

The Euro Summit of 24 October 2014 concluded that "*closer coordination of economic policies is essential to ensure the smooth functioning of the Economic and Monetary Union*". It called for work to continue "*to develop concrete mechanisms for stronger economic policy coordination, convergence and solidarity";* and it invited the President of the European Commission, in close cooperation with the President of the Euro Summit, the President of the Eurogroup and the President of the European Central Bank, *"to prepare next steps on better economic governance in the euro area."*

The European Council of 18 December 2014 confirmed the mandate given to the Four Presidents. As a first step, the Four Presidents were asked to produce an Analytical Note to serve as the basis of a discussion at the informal European Council on 12 February 2015.

The present Analytical Note takes stock of the current state of Economic and Monetary Union (EMU). It identifies the main shortcomings of the EMU framework that were revealed by the crisis, describes the measures taken so far to address them and prepares the ground for a discussion about the next steps. Nothing in this note prejudices the final content of the Four Presidents' Report, which will be drafted in the light of the outcome of the discussion between Heads of State and Government on 12 February and further work and consultations ahead of the European Council in June.

1. The nature of Economic and Monetary Union

The euro is a currency shared today by 19 EU Member States and more than 330 million citizens. In spite of the crisis, it is the second most important currency in the world, with a 24.4 % (1999: 18 %) share in global foreign exchange reserves, compared to the U.S. Dollar's 61.2 % share. Globally, 59 countries and territories have either directly or indirectly pegged their currency to the euro.

The euro is more than a currency. It is also a political project. Our monetary union requires Member States give up their previous national currencies once and for all and permanently share monetary sovereignty with the other euro area countries. The euro has thus created *a "community of destiny"* between the 19 Member States that share the euro as their currency; this requires both solidarity in times of crisis and respect by all for commonly agreed rules.

The euro area has a unique institutional setup. While monetary policy is decided jointly at European level, economic and fiscal policies remain, to a large extent, in the Member States' remit. In such a setup, vulnerabilities in one Member State can become vulnerabilities for the euro area as a whole. Economic success is therefore in everyone's common interest. A monetary union will only be successful if being inside monetary union brings, over time, more benefits as compared to staying outside. For this, all Member States have to take ownership by considering their economic and fiscal policies as a matter of common concern.

The Treaties set out a clear set of goals – inclusive and sustainable growth, price stability, sound fiscal positions and high levels of employment –, and the EMU framework foresees a set of common rules

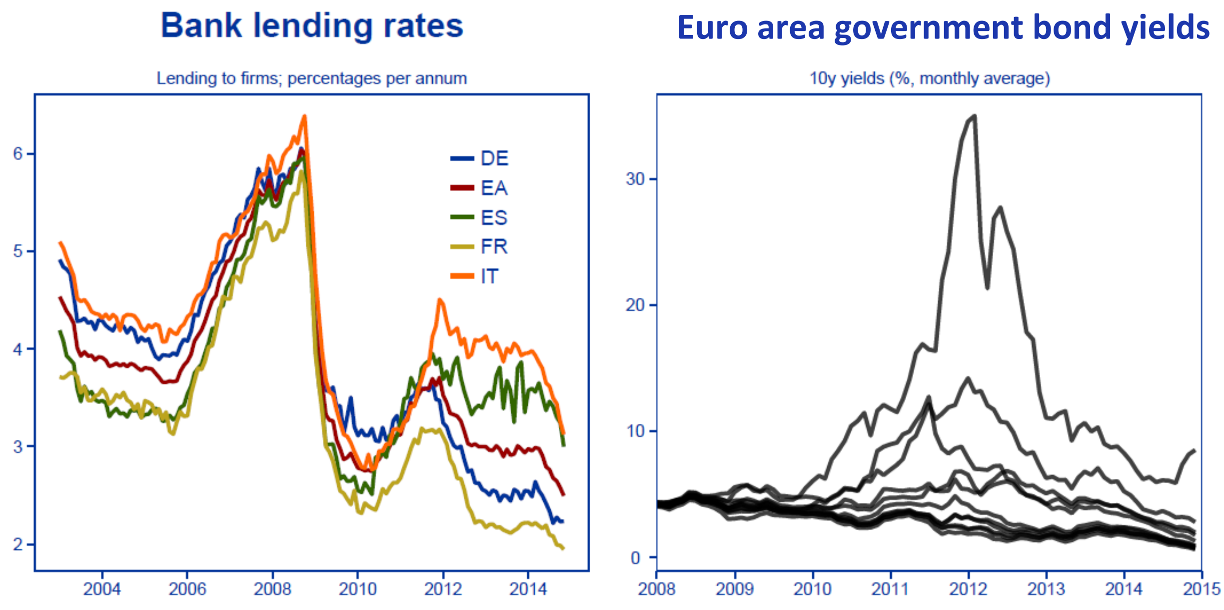
to coordinate these policies closely. The crisis has shown that if there are weaknesses in the framework or if it is not sufficiently implemented, the integrity of the euro area as a whole is at stake and the objectives stipulated by the Treaties cannot be attained. It is for this reason that making sure the EMU framework is fully compatible with the requirements of sharing a common currency was the key challenge faced in recent years and remains a hurdle that has not yet been fully overcome.

2. Looking back: the manifold roots of the crisis

The crisis that started to hit the euro area as of summer 2007 and which continues to impact the economic development of several euro area members until today, had many roots and origins. While several of them are common to all industrialised countries, some of them are more strongly present in the euro area where they prolonged and intensified the effects of the crisis.

At the onset, the crisis was primarily a *financial crisis*. It originated in the U.S. subprime market and spread rapidly across the globally interconnected financial system, including to European banks and other financial institutions, notably in euro area countries where the good times of the first decade of the euro had led to financial and housing bubbles. A feature of particular relevance to the euro area was the negative feedback loop between bank and government sovereign debt: as banks that had become too systemic to fail got into financial difficulties and turned to their sovereign for help, the stability of the banking system could only be guaranteed to the detriment of the public finances of the countries concerned and at the cost of increased financial fragmentation (see **Chart 1**). Thus, in these countries, a crisis of banks quickly became a crisis of public finances, with a direct impact on the real economy.

Chart 1

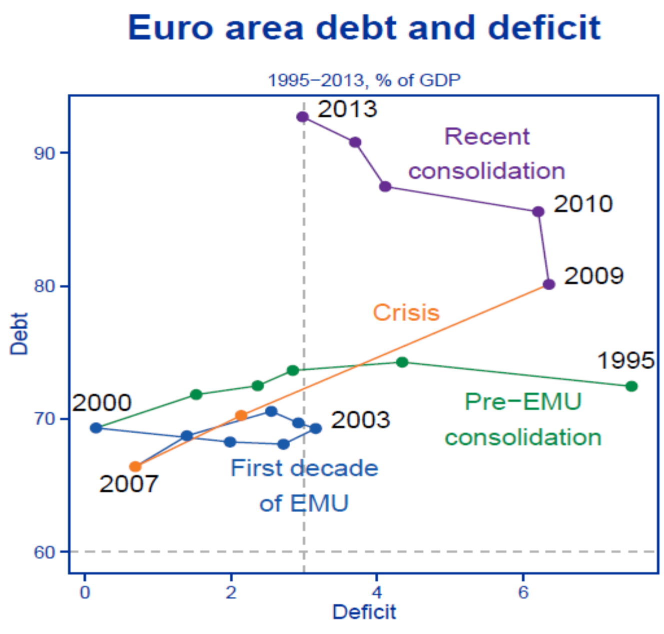


Source: ECB, Reuters, ECB Staff calculations

The crisis then turned into a *sovereign debt crisis*. The first decade of the euro had not led to a sustainable reduction of public debts and deficits below the reference values of 3 % and 60 % of GDP required by the Maastricht Treaty. Government debt in the euro area, which had stood at 72.8 % of GDP in 1998, could only be reduced to 66.2 % of GDP on average in 2007, even though mostly benign macroeconomic conditions would have allowed for stronger fiscal consolidation. Deficits in the euro area stood on average at 1.9 % of GDP in the period from 1999 to 2007, peaking at 3.1 % of GDP in 2003. The common policy objective of national budgets which are in balance or in surplus – meant to reduce public debt levels – could not be reached. The fiscal rules meant to contain excessive public deficits (the so-called "Stability and Growth Pact") were often not respected and not implemented.

Since 1997, most euro area countries (all except Estonia and Luxembourg) were once or even repeatedly subject to an excessive deficit procedure. In 2003, the rules of the Pact were partly suspended by a qualified majority in the Council in the specific case of excessive deficit procedures against Germany and France. In 2005, the Pact was reformed in a manner widely perceived as a weakening of the rules. Both moves undermined the credibility of the Pact. When the crisis started to impact the euro area, its Member States reacted with important stimulus packages and injections of public money into their banking systems, which, while necessary to safeguard financial stability and soften the impact of the crisis, in many countries increased public debt and deficit well beyond the Maastricht reference values. Public deficits in the euro area peaked at 6.2 % of GDP in 2010 before they could be reduced to 2.6 % of GDP in 2014. While public debt continues to increase as a result of the measures taken during the crisis, in 2014, it stood at 94.3 % of GDP on average in the euro area, way above pre-crisis levels (see **<u>Chart 2</u>**).

<u>Chart 2</u>



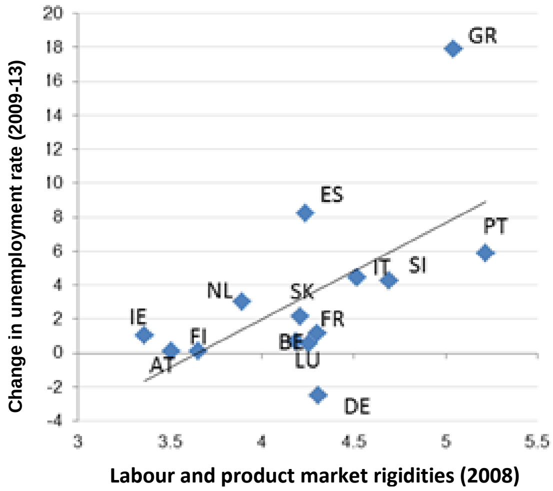
Source: European Commission, ECB

The crisis in the euro area, triggered by the global financial turmoil, can also be said to have been a *competitiveness crisis*, with several weaknesses predating the crisis. While there had been some catching up with the U.S. in terms of productivity until the 1990s, this process has stopped over time. Several euro area countries did not use the boom period to tackle existing rigidities in product and labour markets.

By contrast, deep-rooted vulnerabilities did not allow the supply side to catch-up with demand. At the same time, significant nominal and real rigidities prevented an efficient allocation of resources, including between the tradable and non-tradable sectors, and thereby hampered the functioning of the competitiveness channel (see **Chart 3**).

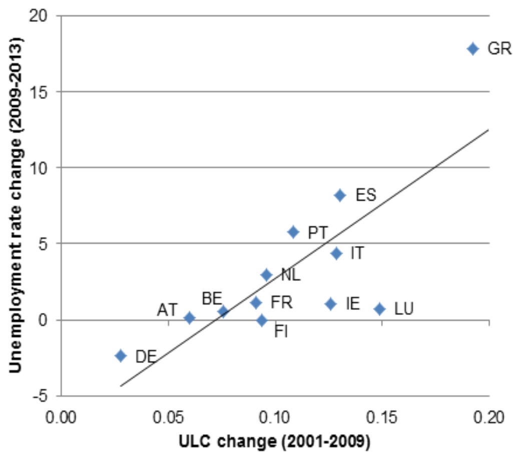
Against this background, during the first decade of the euro, the cost of labour (measured in unit labour costs) grew significantly in a number of euro area countries, making their products more expensive, thereby reducing their competitiveness and leading to a negative balance of payments vis-à-vis other euro area countries which had kept labour unit cost stable or even lowered them.

Chart 3: Rigidities in product and labour market and changes in the unemployment rate (2009-13)



Source: Eurostat and OECD
Note: labour and product market rigidities measured as average of employment protection legislation and product market regulator OECD indicators.

Chart 4: Changes in Unit Labour Costs (2001-09) and in the unemployment rate (2009-13)



Source: Eurostat
Note: Data shown for euro area countries that have joined the EMU before 2002; for unemployment rate September data is used.

This brought about higher unemployment rates during the crisis (see **Chart 4**). In addition, the relatively favourable financing conditions in the first years of the euro led to a misallocation of sources of financing towards less productive forms of investment, such as real estate, and to a greater risk-taking and indebtedness of many private and public actors. When the crisis hit the euro area and markets reappraised the risk and growth potential of individual countries, the loss of competitiveness became visible and led to outflows of sources of finance strongly needed for investment, thereby further intensifying the impact of the crisis in these countries. While several stakeholders at the European level had warned about such developments, the governance framework at the time did not provide for a systematic detection and correction of imbalances and hence it could not prevent their build-up.

Last but not least, the crisis can also be said to be a *crisis of markets* in terms of their capacity to price country risk correctly. While the Maastricht Treaty was based on the assumption that market discipline would be a key element in preventing a divergent development of the euro area economies and their fiscal positions, with increasing government bond interest rates having a signalling effect, this was not the reality of the euro area from 1999 to 2008. Instead, investors treated the euro area as one, without taking into account diverging economic and financial risks. The crisis made these divergences transparent; the ensuing reappraisal of risks then led to bond interest rates for certain euro area countries which were well above those of certain developing countries (see **Chart 1**).

All of these developments showed that there was a significant gap between the objectives and the actual performance of the pre-crisis governance framework of EMU, as well as a persistent failure to comply with and implement commonly agreed policies.

3. Measures taken since 2010 to strengthen the resilience of Economic and Monetary Union

The crisis has revealed that significant structural weaknesses and rigidities and unsustainable fiscal and economic policies in some Member States can undermine the economic development the euro area as a whole and thereby put the benefits of being inside EMU at risk. It has also uncovered major shortcomings of the governance framework, which was not able to prevent these developments.

At euro area level, significant reforms have been adopted since 2010 with a view to addressing and remedying these deficiencies:

- The **European Stability Mechanism (ESM)** was created as a permanent crisis mechanism tool that had not been available before the crisis.

- **Banking Union** was established, with the ECB taking up the role of the Single Supervisory Mechanism, directly supervising all significant banks in the euro area since 1 November 2014. The Single Resolution Mechanism and the new bail-in rules of the EU Bank Recovery and Resolution Directive now provide a framework for the orderly resolution of banks and for burden-sharing between shareholders and creditors. These steps, coupled with the Single Resolution Fund, are important contributions to reducing the detrimental sovereign-bank nexus and to protecting, alongside harmonised national deposit-guarantee schemes, depositors.

- The new **Macroeconomic Imbalance Procedure (MIP)** is now in place to detect the development of macroeconomic vulnerabilities early on and provide instruments to correct them.

- The **reform of the "Stability and Growth Pact" in 2011/2013 and the agreement on the "Fiscal Compact"** reinforced the fiscal framework in order to prevent the building up of large fiscal imbalances in the future. The monitoring of expenditure developments became more important under the preventive arm and the procedures in the preventive and corrective arm were strengthened – not least by new, earlier and gradually increasing sanctions. One major lesson from the crisis was the need to introduce a numerical debt benchmark aiming to ensure convergence towards sound debt ratios, below the Maastricht reference value of 60 % of GDP. The introduction of the reverse qualified majority voting modalities (RQMV) in the Council for decisions under the excessive deficit procedure was intended to increase the quasi-automaticity of the procedures.

- **Eurostat** powers were strengthened in 2011 with regard to statistical data used for the excessive deficit procedure. Under the amended regulation, today Eurostat is entitled to examine Member States' public accounts and to make on-the-spot investigations in the Member State concerned.

These are important steps which would likely have improved the euro area's performance considerably, both before and during the crisis, had they already been in place a decade ago. Nonetheless, these new structures will only be effective if fully implemented both at EU and national level.

4. Where do we stand now?

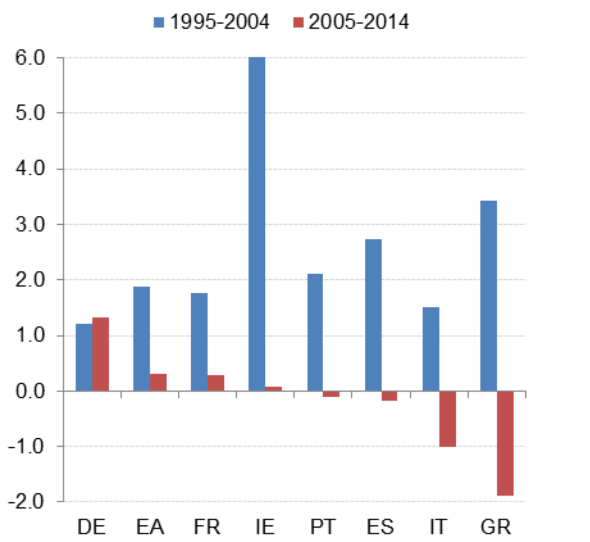
Although a significant adjustment of fiscal and economic imbalances has started, in particular in countries under EU/IMF financial assistance and other more vulnerable euro area countries, the legacy of accumulated imbalances remains painfully visible: unemployment rates have soared and public and private sector debt increased very significantly in just a few years. Unemployment in the euro area has been above 10 % since 2009 and stood at 11.6 % in 2014, up from 7.5 % in 2007. Youth unemployment in the euro area even stands at 23 % (up from 16.6 % in 2007).

High indebtedness and unemployment and the still significant obstacles to flexible markets, hamper countries' growth potential (see **Chart 5**). Moreover, while high debt usually has a negative effect on growth (see **Chart 6**), low growth and low inflation also make it difficult for a country to reduce its indebtedness, with the aim of increasing resilience and sustainability. In this context, some of the highly indebted euro area countries with low rates of potential output growth may find it particularly difficult to reduce their debt levels quickly. Increased shock resilience and higher potential growth demand further action in terms of national structural reforms.

According to international indicators of labour and product market flexibility, euro area countries still exhibit significant rigidities which need to be tackled. Moreover, national governments need to create an environment which is favourable for entrepreneurs wanting to start a new firm or for existing firms to grow. International indicators suggest that there is significant scope for improvement in the euro area: currently, when looking at its overall position in the world, the euro area ranks far beyond the UK and the U.S. on average.

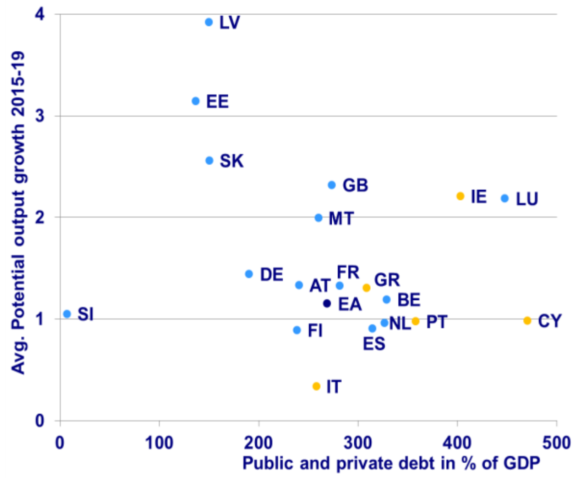
In the World Bank rankings on the ease of doing business, there is only one euro area country (Finland) in the top 10, and several countries are not even in the top 50. Measures to improve this are not only in the best interest of each Member State – because of the strong links between Member States' economies – but they are also in the interest of the euro area as a whole.

Chart 5: Real GDP per capita *(average growth)*



Source: European Commission

Chart 6: Average potential growth vs. public and private debt



Source: European Commission, Eurostat
Note: Last observation refers to June 2014 for public and private sector debt and 2019 for potential output.

5. Looking forward: towards a deep and genuine Economic and Monetary Union

In view of the current weak economic environment in the euro area as a whole and the remaining vulnerabilities and rigidities in a number of individual countries, there is a need to move gradually towards *"concrete mechanisms for stronger economic policy coordination, convergence and solidarity".* Such mechanisms should be based on the reality of the economic, employment and social situation of euro area Member States, the nature of the interdependency which exists between them, and their capacity to converge over time.

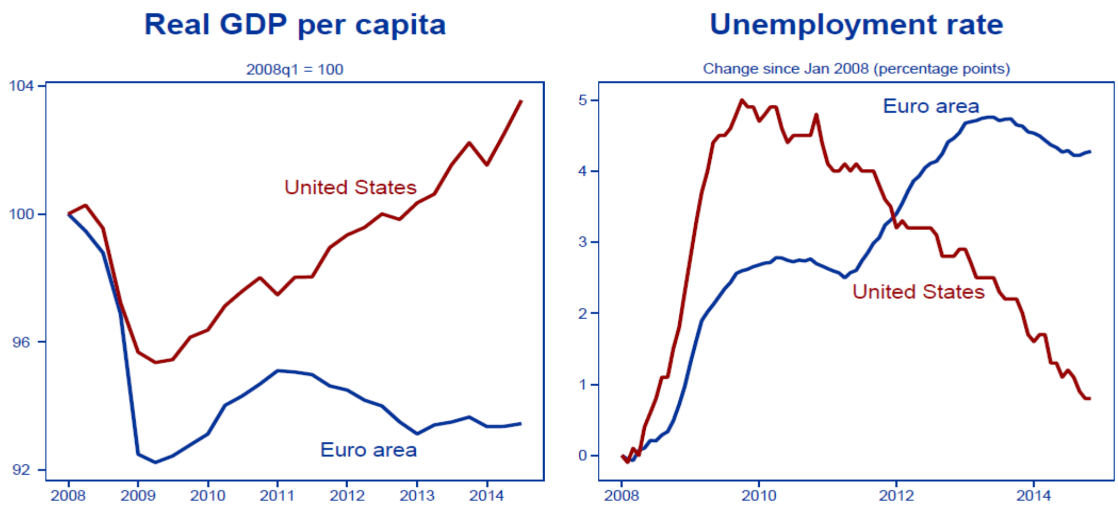
In the short run, it is important to implement a consistent strategy around the "virtuous triangle" of structural reforms, investment and fiscal responsibility and in this context move **towards more effective commitments to growth-enhancing structural reforms in the euro area**. The policy commitments of euro area countries, made individually or collectively, to growth-enhancing structural reforms have not been implemented satisfactorily. Often, commitments are strong in crisis times and then weakened again when the overall economic climate has improved. In this sense, the stabilising effect of the single currency has certain counterproductive effects with regard to the willingness of national governments to start and implement the necessary structural reforms with decisiveness, though these would be urgently needed. A renewed political consensus at the highest political level is necessary to proceed with those structural reforms which should be tackled as a priority across the euro area.

Moreover, **the functioning of the Single Market** needs to be improved, in particular in areas that are vital to increase the adjustment capacity of the euro area economies. **Enhancing labour mobility** is key in this respect. In addition, to complement Banking Union and diversify and extend sources of financing of the European economy, we need to address remaining barriers to investment and the free movement of capital and **make capital market integration a political priority**, including by considering issues like taxation, insolvency and company law. A well-integrated financial system in the EU, as a result of a Capital Markets Union, can make a monetary union more resilient against shocks by providing an element of private risk-sharing, and more efficient when it comes to generating jobs, growth and investment. Further initiatives to complete the Single Market, for example, in the areas of the digital economy and energy, are essential to strengthen growth prospects.

Tangible progress on these two blocks – growth-enhancing structural reforms and deepening the Single Market – will contribute to the smooth functioning of Economic and Monetary Union in the short term (within the next 18 months), provided that they receive strong political backing.

However, it remains **necessary, for citizens and markets alike, to develop a long-term perspective on how the framework of EMU should develop**, where it could be considered complete, and where further work will be necessary to develop stronger common governance, as already called for by the 2012 Four Presidents' Report and by the Commission's Blueprint, which both remain valid. The euro area has not recovered from the crisis in the same way as the U.S., which might point to the fact that an incomplete monetary union adjusts much slower than one with a more complete institutional setup in place (see **Chart 7**).

Chart 7



Source: Eurostat

In this respect, this Analytical Note is intended to start a discussion process that will feed into a forward-looking report by the Four Presidents, in the preparation of which all Member States will be closely involved[1] and which could in particular address the following questions:

- How can we ensure sound fiscal and economic positions in all euro area Member States?
- How could a better implementation and enforcement of the economic and fiscal governance framework be ensured?
- Is the current governance framework – if fully implemented – sufficient to make the euro area shock-resilient and prosperous in the long run?
- To what extent can the framework of EMU mainly rely on strong rules and to what extent are strong common institutions also required?
- What instruments are needed in situations in which national policies continue – despite surveillance under the governance framework – to go harmfully astray?
- Has the fiscal-financial nexus been sufficiently dealt with in order to prevent the repetition of negative feedback loops between banks and sovereign debt?
- How could private risk-sharing through financial markets in the euro area be enhanced to ensure a better absorption of asymmetric shocks?
- To what extent is the present sharing of sovereignty adequate to meet the economic, financial and fiscal framework requirements of the common currency?
- Is a further risk-sharing in the fiscal realm desirable? What would be the preconditions?
- Under which conditions and in which form could a stronger common governance over structural reforms be envisaged? How could it foster real convergence?
- How can accountability and legitimacy be best achieved in a multilevel setup such as EMU?

[1] The President of the European Commission has indicated his intention to draw on input from the President of the European Parliament in his reflections during the preparation of the report.